Purdue University

Purdue e-Pubs

Historical Documents of the Purdue Cooperative Extension Service

Department of Agricultural Communication

12-1-1982

Individual Retirement Accounts

Purdue University Cooperative Extension Service

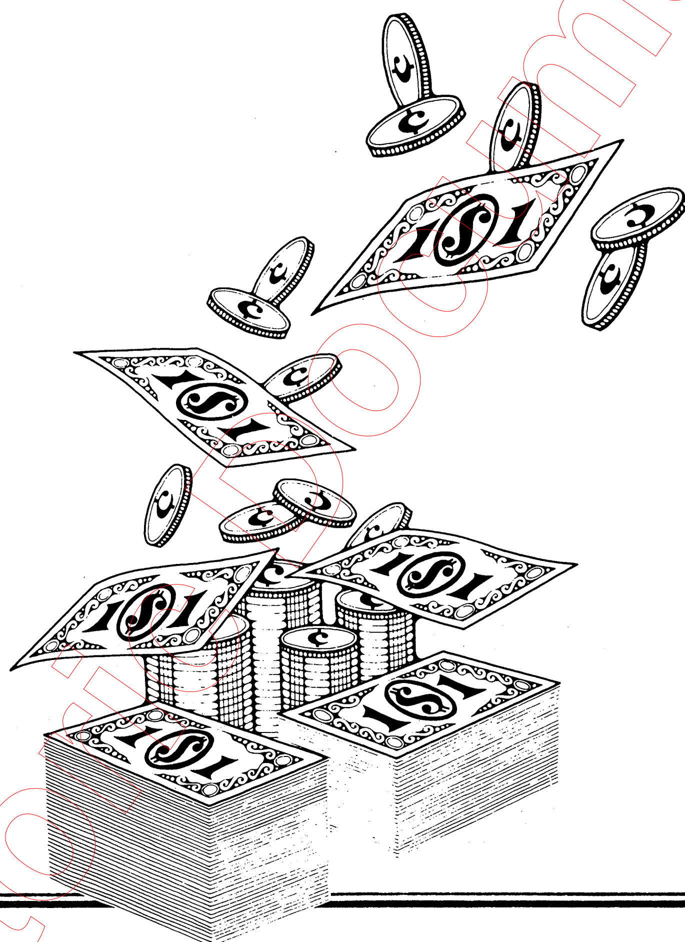
HE-301

$ PUT YOUR $ TO WORK $

New
Com
Yes

Individual Retirement Accounts

Cooperative Extension Service, Purdue University, West Lafayette, Indiana



The $2,000 earned income is, after taxes, actually only $1,200.

$2,000 (earned income)	$2,000 (earned income)
x.40 (40% tax)	-$800 taxes
$ 800 in taxes	$1,200 left to invest

Taxes also take 40% of the interest earned on the contribution; so the 10% return is reduced to 6%.

10 (10% return)	10 (10% return)
x.40 (40% tax rate)	-4 (% return after tax)
4 (% return after tax)	6 (% net interest earnings after tax)

	Without IRA	With IRA
Net deposit	$ 1,200	$ 2,000
Net interest earnings	6%	10%
Fund at age 65	$196,858	$973,704

The total dollar amount saved for retirement in the non-tax sheltered account is $196,858. The amount in the IRA is $973,704, thanks to the tax-sheltered status.

Who is eligible for an IRA?

Since January 1, 1982, consumers under the age of 70½ with earned income can contribute up to $2,000 a year to an Individual Retirement Account whether or not they are covered by an employer's pension or profit sharing plan. The married person whose spouse is not employed can contribute to a special spousal IRA in his or her name, boosting the annual deduction to $2,250. The total can be split as you wish between the accounts as long as at least $250 is deposited into the non-employed spousal account.

The retirement picture of both spouses should be considered in deciding how to allocate this $2,250. If the husband has a pension plan with his employer and the wife has none, an equitable allocation might be to place $2,000 into the wife's account and $250 into the husband's account.

When both spouses are employed, each can have an IRA, making a possible annual tax write-off of $4,000. A divorced, non-working spouse may count alimony as earned income, thus becoming eligible for participation in an IRA.

Are there other restrictions on contributions?

You can contribute as much as $2,000 a year to an IRA plan as long as you earn that much. If you earn less than $2,000, you can contribute 100% of your income. This is a major benefit for part-time workers.

You do not have to make the whole year's deposit at once nor do you have to contribute every year. If you have unanticipated expenses and cannot contribute anything in a given year, this does not cancel the plan. However, a missed yearly contribution cannot be made up in subsequent years.

IRA contributions may be made up to 3½ months after the end of the owner's tax year. This means that a calendar year taxpayer has until April 15 to calculate his or her total earnings before deciding how much money can be set aside that year.

How are withdrawals regulated?

Savings in an IRA cannot be withdrawn before 59½ years of age (except in case of permanent disability or death) without losing some of the interest earned. In addition, tax is levied for the year in which the amount is received plus a 10% penalty on the amount withdrawn.

However, the IRA investor reaches a break-even point about 3 to 5 years after the dollars go into the account. In other words, assuming a 12% return and a 35% tax bracket, the investor who must withdraw funds after five years does better *after tax and penalty* than he/she could have by investing in taxable instruments in the first year. In effect, the tax-free accumulation on the larger, initial investment will more than offset the penalty after a period of time. This varies, of course, with rate of return and tax bracket. The following table can help you predict your break-even point.

In reading the table, first identify your approximate, average tax bracket for the next few years. Then identify the annual rate of return you expect on your investment. The figures will give you the approximate year and quarter at which you would be just as well off withdrawing the money from an IRA as you would be if you had placed the money in the same investment without the tax-sheltered status.

IRA Tax Penalty Neutralization: Break-even Point

The number at the right of the decimal is equal to the number of quarters, i.e., 4.3 = 4¾ years.

Rate of Return	Tax Bracket .25	.30	.35	.40	.45	.50
.08	7.3	7.0	6.2	6.1	6.0	6.0
.10	6.1	5.3	5.1	5.0	5.0	5.0
.12	5.2	4.3	4.2	4.1	4.1	4.1
.14	4.3	4.1	4.0	3.3	3.3	3.3
.16	4.1	3.3	3.2	3.1	3.1	3.1
.18	3.3	3.2	3.1	3.0	3.0	3.0

This table reprinted with permission from the Journal of Retail Banking (Vol. 4, No. 1) © the Consumer Bankers Association.

From 59½ to 70½ years of age, you can withdraw as much or as little as you like, with a specified withdrawal schedule beginning the year you reach 70½. In terminating your IRA, you can take the money over a period of years to minimize tax liabilities. As funds are withdrawn, you are taxed on them. At that time, however, taxable income is likely to be lower.

What kind of investments can I use for my IRA?

All traditional investments are eligible for tax-sheltered IRA plans, including mutual funds, stocks, bonds, annuities and savings accounts. Investments that are not eligible include precious metals, antiques, stamps, works of art or other tangible personal property defined by the Internal Revenue Service.

The choices

Once you have decided to open an IRA, your next and most difficult decision will be choosing how to invest your money. Before shopping around, you should determine your retirement goals. For example:

- Do you want to assume some risk, or would you feel more secure knowing that your money is insured and earning a fixed rate?

- Do you have the time and skill to manage investments, or would you rather have a professional making the decisions?

- Do you want to put your money in one type of investment and leave it there, or would you prefer the flexibility of moving your money from one investment to another?

Another factor to consider is how the IRA fits into your overall retirement planning. If you are counting on it to provide most or all of your retirement income, you may want to be more conservative than someone whose IRA is less important due to expected benefits from Social Security, a pension, or outside investments. Your age can also make a difference. A young person may choose riskier investments, with time to make up any early losses. In this event, investments should offer a high rate of return to justify the risk. A person nearing retirement, on the other hand, would prefer an investment with a guaranteed yield.

Where can I make my IRA contributions?

Accounts are offered by banks, credit unions, savings and loans, mutual funds, insurance companies and brokers. In addition, if you are covered by a company plan permitting voluntary contributions, you may be able to make your payments through payroll deductions.

May I have more than one account?

You may pick more than one type of investment, and you may open as many IRAs as you want as long as the total annual contribution does not exceed $2,000. Annual administrative fees and the extra paperwork may make it impractical to open very many accounts, but you may want more than one so you can spread your money among different investments. You can move your money from one investment to another if you make sure the check is made out to the trustee of the new IRA. If the check is made out to you, you can move your money only once a year. Also, the money must be reinvested in another IRA within sixty days to avoid penalty.

What are the alternatives for IRA funds?

Major financial institutions now offering IRA options are commercial banks, brokerage firms, mutual funds and insurance companies.

Banks and thrifts. You can put your IRA contributions into any savings account or certificate of deposit up to $2,000. Some banks offer rates that fluctuate with the market, some offer rates that are fixed for varying periods, and some offer guaranteed floors. If safety is your primary concern, all bank deposits up to $100,000 in the same name are insured by the federal government.

Most bank IRAs earn compound interest, but some are compounded daily, making your effective rate higher than the flat rate. Banks are now free to pay market rates on IRA savings certificates of 18 months or more, helping you to keep ahead of inflation. Rates and compounding intervals vary. To compare actual yields, ask each institution what your earnings will be in one year on $1,000.

A plus factor—most banks and thrifts do not charge a fee to set up or administer your IRA. However, they may limit your flexibility in changing investments by imposing penalties of their own for early withdrawal. In the case of a rollover IRA, a management charge may be assessed.

Brokerage firms. Brokers offer a wide array of investment choices but require the most active management. You can buy and sell stocks and bonds, although speculative investments are risky for retirement savings. These accounts are not insured, and your principal will fluctuate with the market.

With stocks in an IRA, you lose the tax advantage of lower capital gains because ultimately all IRA earnings are taxed as ordinary income. Also, you cannot write off capital losses or buy stocks on margin.

Brokers usually charge fees for setting up IRAs plus annual maintenance charges. There is also a commission every time you buy or sell. You may choose to manage your IRA yourself if you have the time and skill, or you can buy shares in professionally-managed mutual funds sold by firms. If you are interested in a self-directed plan, be aware that in the early years of your IRA, the fees could eat up much of your profit. Some advisors recommend that you build your account to $10,000 or so before shifting to a self-directed plan.

Mutual funds. Although they are not insured, no-load mutual fund families offer attractive IRA deals. They have low costs, a wide choice of investments and ease of switching from one type of fund to another as often as you want, depending upon interest rates and changing economic conditions. Typically, mutual funds carry a maintenance fee, but there is no sales fee and no fee for switching between funds within the same group. As with stocks, you lose some tax advantages if you invest your IRA dollars in certain kinds of funds. In addition, your principal is not insured.

Insurance companies. The basic product is a flexible annuity in which your contributions are invested by the company. You decide when and how much to contribute to the plan. When you sign up, you are guaranteed a minimum rate of return. However, the current rate, which is what you receive, changes periodically according to how the company's investments are doing.

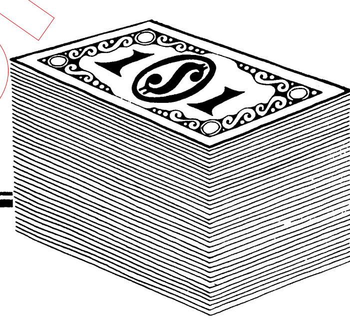
Annual maintenance fees for annuity IRAs may be higher than mutual funds, and you should also check load charges. Although some companies have front-end loads (commission charges when you buy), IRA annuity plans more commonly have back loads (penalties for premature withdrawal).

The main advantage of an annuity is the guarantee that you will receive a certain income every year which you cannot outlive. However, regardless of where you accumulate your IRA cash, you can use it to buy an immediate-pay annuity when you retire, as long as you do so before age 70½.

Payroll Deduction. IRA sponsors are heavily promoting payroll deduction plans. If this is provided by your employer, be aware that the IRA is identical to one you would buy on your own. The difference is that, rather than sending the money to the sponsor yourself, it is deducted from your check. An attraction to these programs is that the company may pay all the fees for participating employees. Every dollar of employee IRA investment goes to the investment rather than part investment, part fee. The choice of investment vehicle is still yours, so compare what is offered with other plans.

Wherever you put your first contributions, it is important to keep an eye on your money and to continue to compare with other investments. The more you learn about the options available, the better prepared you are to shift your money to take advantage of changing conditions.

It is important to remember that in an IRA nothing is forever. You do not have to make an investment decision at age 35 that you are stuck with until retirement. Changes can be made in the investment of IRA funds, as each annual contribution is independent of any other.



The Distribution of Your IRA at Retirement

Basically, you can begin making withdrawals at age 59½, although you do not have to start taking the money out until the end of the year in which you reach age 70½. Once you reach at least age 59½, you can vary annual withdrawals to coincide with ups and downs in other earnings or capital gains to minimize the tax bite. One advantage to leaving as much of your savings in an IRA for as long as possible is that the balance continues to grow tax free. At current interest rates compound earnings could more than offset the annual withdrawal for many years.

You can withdraw the funds in installments or in a lump sum to purchase an annuity or other kind of investment. Either way, the money is taxable as ordinary income in the year you receive payments. The alternative to yearly payouts is withdrawing all of your funds and paying ordinary tax on the entire amount. If you do so, you may be eligible for the five-year income averaging that you can use any time your taxable income takes a big jump in one year.

Because the purpose of an IRA is to increase your retirement income, a severe penalty tax is assessed by the year in which you reach 70½ if you do not withdraw the funds as required. In that year and each subsequent year, the minimum payment that must be made is an amount large enough to liquidate your account over your remaining life expectancy or the joint life expectancy of you and your spouse. At age 70, the life expectancy for a male is approximately 12 years. Therefore, the minimum distribution for payments starting at that time must be at least 1/12 of the balance of the account. If you withdraw an amount less than the minimum allowable payment, a penalty tax is assessed equal to 50% of the difference between what the withdrawal should have been and the amount you actually took. For example, if your minimum required payment is $1,500, but you withdraw only $1,000, the tax would be $250 (50% of $500). This is in addition to any income tax payable.

How much will my retirement fund be worth?

Much of the advertising associated with IRAs indicates that you can become a millionaire. While this may be true, the important consideration is how much that money will buy in the future - how many real dollars you will have.

For example, if you invested $2,000 a year for 40 years at a 12% rate of return, you would have $1,530,000 for retirement. But this would be nominal dollars. How much of the good life will that $1,530,000 buy in terms of today's dollars (real dollars)? At an estimated 9% annual inflation rate over the next 40 years, it would purchase about what $48,700 would today. A 9% inflation rate cuts your 12% rate of return down to a real return of only 3%.

This example assumes that your annual contribution would continue to be limited to $2,000 each year for the next 40 years. At 9% inflation per year, $2,000 nominal dollars would be worth only about $64.00 in that fortieth year.

There are two possible alternatives. Inflation may be curbed or the legislature could be encouraged to index the ceiling on IRA contributors, allowing the contribution to remain at the real $2,000 value over time. If contributions were indexed, the $2,000 real dollars per year over 40 years, with a real rate of return of 3% (12% interest minus 9% inflation), would result in a retirement fund of approximately $150,000.

What happens to remaining IRA funds at death?

If you die before the entire amount of your IRA has been paid to you, any balance remaining will be paid to your designated beneficiary. This payment can be a lump sum or in installments over a period of time that does not exceed the life expectancy of the beneficiary. If no such payment method has been selected and no distribution made by five years from the date of the account owner's death, the funds will then be treated as though they were in an IRA for the named beneficiary. From that time, the amount in the account will be subject to all regulations that apply to the distribution of IRA funds.

Funds in your IRA account upon death will be included in your estate for federal estate tax purposes if such funds are paid to your estate or if they are paid to your beneficiary over a period of less than 36 months. IRA funds remaining unpaid at death would not be included in your estate if they are paid to a named beneficiary and are payable in installments over a period of 36 months or more.

Sources

"Is There an IRA for your Future?," *Consumer Views, Citicorp,* February 1982.

"Where to Stash your IRA Cash," *Changing Times,* February 1982, pp. 34-42.

"20 Questions Answered about IRA's," *Money,* April 1982, pp. 69-72.

"IRA's," Journal and Courier, January 17, 1982, B-7.

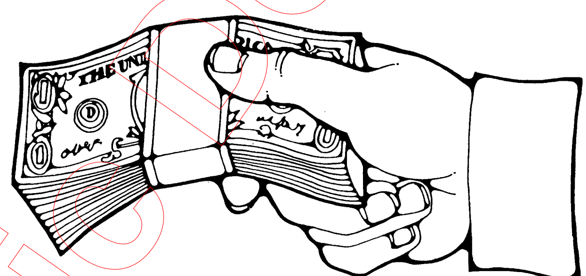
"To Decide Where to Put Your IRA Dollars, Look at Risks, Management and All the Fees," Wall Street Journal, Monday, December 14, 1981.

Thorkelson, Thomas L., *IRA: Boon or Boondoggle?* The Research and Review Service of America, Inc., Indianapolis, Indiana, 1982.

Plan Tomorrow Today With Your Own IRA, Investment Company Institute, 1982.

Journal of Retail Banking (Vol. 4, No. 1) © The Consumer Bankers Association.

Morgan, James N. and Greg, J. Duncan, *The Economics of Personal Choice.* Ann Arbor, Michigan: The University of Michigan Press, 1980.



NEW 12/82

Cooperative Extension Work in Agriculture and Home Economics,
State of Indiana, Purdue University and U.S. Department of Agriculture Cooperating.
H. G. Diesslin, Director, West Lafayette, IN.
Issued in furtherance of the Acts of May 8 and June 30, 1914.